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INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

DISTRICT,

FROM: CHIEF, BRANCH TWO , OFFICE OF ASSOCIATE CHIEF
COUNSEL, CC:EBEO:2

SUBJECT: Employment Taxes – taxable year

This Field Service Advice responds to your memorandum dated March 17, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Company =

Plan =

ISSUE:

Whether bonuses paid to employees of the Company in are considered amounts deferred under a nonqualified deferred compensation plan that should be taken into account under Treas. Reg. § 31.3121(v)(2)-1(b)(3)(i) as FICA wages in

CONCLUSION:

Based on the factual information available, bonuses paid to employees of the Company in are not amounts deferred under a nonqualified deferred compensation plan because the employees did not have a legally binding right in to those amounts under Treas. Reg. § 31.3121(v)(2)-1(b)(3)(i).

FACTS:

In _____, the Company paid bonuses to certain management employees totaling \$ _____. The Company reported the bonus payments as wages paid to employees during _____. On _____, the Company filed Form 843, Claim for Refund and Request for Abatement, in the amount of \$ _____, for refund of FICA taxes on those bonuses. The Company claims that the bonuses paid in _____ were fully vested in _____ and that, pursuant to the regulations under section 3121(v)(2), those amounts should have been taken into account as wages in _____.

The Form 843 states that all employees who received bonuses in _____ had already earned FICA wages in excess of the \$ _____ Hospital Insurance (HI) wage base in _____. Accordingly, the Company claims that taking the bonuses into account in _____ does not result in any additional HI liability for _____.

When asked for copies of compensation plans in effect during _____, the Company provided the employment tax examiner with a brochure describing the plan. The Company asserts that the brochure was the only written plan document for that year.

The plan brochure provides that incentive pay is a component of the Company's annual compensation. The plan brochure discusses performance award opportunities and a fund to provide special recognition for exceptional contributions to the Company. The Company's incentive programs award exceptional performance by teams and individuals. Each organization within the Company is permitted to develop its own plan with its own guidelines for up to one half of its award allotment. Although the plan brochure provides that each organization can provide details of its own plan, no such information was provided to the employment tax examiner.

The plan brochure also provides that management employees who perform at or above satisfactory levels are eligible for bonuses, but those bonuses may be reduced or withheld if an employee does not meet job expectations. The plan brochure provides sample calculations of bonus awards based upon levels of attainment with respect to various goals. Adjustments are made for various changes in status (such as retirement, promotion, movement between different organizations within the Company, etc.)

Under the provision entitled "_____", the plan brochure provides that awards are paid as soon as possible after the end of the year. The last page of the plan brochure contains a statement that the plan brochure is provided for employees' information only, it is not a contract, and that the Company unilaterally reserves the right to alter, amend, modify, change or terminate any provisions without notice to employees.

LAW AND ANALYSIS:

The Federal Insurance Contributions Act (FICA) taxes consist of the old-age, survivors, and disability insurance (OASDI) taxes imposed under §§ 3101(a) and 3111(a) of the Code and the hospital insurance (medicare) taxes imposed under §§ 3101(b) and 3111(b).

FICA taxes are computed as a percentage of "wages" paid by the employer and received by the employee with respect to "employment." In general, all payments of remuneration by an employer for services performed by an employee are subject to FICA taxes, unless the payments are specifically excepted from the term "wages" or the services are specifically excepted from the term "employment." Section 3121(a) of the Internal Revenue Code defines "wages," for FICA tax purposes, as all remuneration for services, with certain exceptions not applicable here. Bonus payments are wages because they constitute remuneration for services. Section 3121(a)(1) imposes a dollar limit on the annual amount of wages subject to the OASDI portion of FICA tax. Section 13207 of the Omnibus Budget Reconciliation Act of 1993 repealed the dollar limit on the annual amount of wages subject to the HI portion of FICA tax, effective for 1994 and later years.

Section 3121(v) provides for the FICA tax treatment of nonqualified deferred compensation plans. Under Code section 3121(v)(2)(A), any amount deferred under a nonqualified deferred compensation plan must be taken into account as wages for FICA tax purposes as of the later of (1) when the services are performed or (2) when there is no substantial risk of forfeiture of the rights to such amount. This special timing rule may result in the imposition of FICA tax before the benefit payments under the plan begin.

Section 3121(v)(2)(B) provides a special exclusion (the nonduplication rule) that prevents double taxation. Once an amount deferred under a nonqualified deferred compensation plan is taken into account as wages under the special timing rule, the nonduplication rule provides that neither that amount nor the income attributable to that amount is again treated as FICA wages. Thus, benefit payments under a nonqualified deferred compensation plan are not subject to FICA tax when actually or constructively paid (i.e., under the general timing rule for wage inclusion) if the benefit payments consist of amounts deferred under the plan that were previously taken into account as FICA wages under the special timing rule plus attributable income. The Company asserts that the bonus payments were amounts deferred in , that those amounts should have been taken into account for FICA purposes in , and that all amounts paid in should therefore not be subject to FICA tax. Because all employees receiving bonuses in were above the HI wage base for that year, no FICA taxes would need to be paid with respect to the bonus amounts if the bonuses paid in were in fact deferred compensation earned in .

Section 3121(v)(3) provides that a "nonqualified deferred compensation plan" means any plan or other arrangement for the deferral of compensation other than a

plan described in § 3121(a)(5). Treasury Regulations under § 3121(v)(2) provide guidance for determining whether a plan provides for the deferral of compensation. Under Treasury Regulation § 31.3121(v)(2)-1(b)(3)(i), a plan provides for the deferral of compensation with respect to an employee only if, under the terms of the plan and the relevant facts and circumstances, the employee has a legally binding right during a calendar year to compensation and, pursuant to the terms of the plan, that compensation is payable in a later year. An employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer after the services creating the right to the compensation have been performed.

Based upon the facts presented, the Company's plan does not constitute a nonqualified deferred compensation plan within the meaning of § 3121(v)(2) and the regulations thereunder. The plan states that the Company unilaterally reserves the right to alter, amend, modify, change or terminate any provisions without notice to employees. When an employer retains the discretion to adjust or eliminate compensation, employees do not have a legally binding right to plan payments until payment is actually made. If the Company can eliminate a bonus any time prior to payment, then the employees do not have a legally binding right to that bonus within the meaning of § 31.3121(v)(2)-1(b)(3)(i). Accordingly, the plan is not a nonqualified deferred compensation plan for purposes of § 3121(v)(2) and is therefore not subject to the special timing rule under section 3121(v). Instead, the general timing rule for FICA taxation applies. See generally § 31.3121(a)-2(a). That is true even though all services required to earn the bonus have been performed. Until the bonus is actually paid, the employer has the discretion to reduce or eliminate the payment. Therefore, no deferred compensation exists. See § 31.3121(v)(2)-1(b)(5), Example 6. In that situation, the amount of the bonus should be treated as wages in the year in which it is paid.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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¹ Section 31.3121(v)(2)-1(a)(3)(iii) provides that if an amount is deferred from a calendar year to a date that is not more than a brief period of time after the end of that calendar year (determined in accordance with §1.404(b)-1T, Q&A-2) , then, at the employer's option, that amount may be treated as if it were not subject to § 3121(v)(2). However, an employer may apply this option only if the employer does so for all employees covered by the plan and all substantially similar nonqualified deferred compensation plans. Disparate treatment of employees under the same plan is not permitted.

In conclusion, we recommend further development of the facts in this case. However, based upon the available facts, we recommend denial of the claim. If you have any further questions, please call Branch Two at (202) 622-6040.

JERRY E. HOLMES
Chief, Branch 2
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)